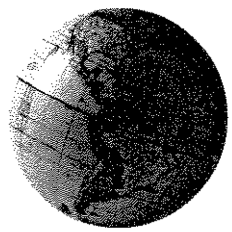
SPRING 2003

Antitrust Report



Effectively Advocating Efficiencies in Merger Reviews
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Legal Privilege in Australian and International Competition Law Investigations
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ROLE OF EFFICIENCIES IN COMPETITIVE EFFECTS ANALYSIS

Contrary to the claims of some practitioners, efficiencies now play a critical role in the U.S. agencies' evaluation of the likely competitive effects of proposed mergers. Indeed, efficiencies were the central issue in the Justice Department's ("DOJ") Antitrust Division's ("Division") two most visible merger challenges during my tenure there:

(1) General Dynamics/Newport News; and
(2) EchoStar/DirecTV.

Both the Division and the Federal Trade Commission ("FTC") have gained substantial experience evaluating efficiencies claims over the five years since the 1997 revisions to the 1992 joint DOJ/FTC Horizontal Merger Guidelines.

Efficiencies are soon to become an equally important part of merger enforcement on the other side of the Atlantic as well. Competition Commissioner Mario Monti, in a series of speeches, has expressly eschewed the idea that efficiencies might provide a basis for challenging a merger—the so-called efficiencies offense—and has said to the contrary that efficiencies may provide

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a basis for approving some mergers that might otherwise be viewed as anticompetitive.[1] The proposed merger guidelines the European Commission ("Commission") published in December 2002 propose to integrate efficiencies into the Commission's competitive effects analysis in a manner that closely tracks the 1997 revisions to the Horizontal Merger Guidelines. Two of the national competition authorities, the United Kingdom and Ireland, have also published proposed merger guidelines within the last six months, both of which also incorporate efficiencies into the competitive effects analysis.

Given the increasingly crucial role efficiencies are likely to play in future merger reviews on both sides of the Atlantic, I offer ten observations in not-quite random order.

First, efficiencies matter. It is always amazing to hear some leading merger practitioners claim that efficiencies will almost never make a difference because the agencies will always find some way to discount them in cases where the merger, without the efficiencies, would otherwise be anticompetitive. That claim tells us more about the ability of the lawyers making it than it does about agency practice.

My experience over the more than twenty-five years I have been practicing antitrust law, including one year at the Division, is directly to the contrary. In a paper Andrew R. Dick and I ("*Dick/Kolasky Paper*") wrote for the Division's twentieth anniversary party for the 1982 Merger Guidelines reviewing how the agencies' treatment of efficiencies has evolved over the years, we described five mergers, including one merger to monopoly, that were cleared by the agencies in large part because of the efficiencies they were expected to deliver.[2] These are only a small sample of a much larger number of such cases at both the Division and the FTC.

One of the most frustrating arguments I used to have was with European practitioners who would insist that we not tell the Commission about the efficiencies we expected to realize because they would be held against us, either because they would result in a loss of jobs or because they would entrench a "dominant" position. The defense offered by some Commission officials to their decision in *GE/Honeywell* contending that General Electric never advanced any efficiencies claims in support of its proposed merger shows the danger of not telling the Commission about the efficiencies one expects to realize.[3]

It cannot be denied, however, that in the past U.S. agencies have sometimes been unduly hostile toward efficiency claims. FTC Chair Timothy J. Muris and I have written articles making that very point.[4] From discussions with officials at the Division and the FTC, I apprehend that any such residual hostility toward efficiency claims is rapidly diminishing. Both at the staff and senior decision-making levels, the two agencies are now more receptive to good efficiency claims than they have ever been.

It is almost always more effective to bring the CEO or another senior executive into the agency and let them tell the story themselves.

Part of the problem is that the agencies do not see very many good efficiency claims. Too often parties and their advisors invest too little time and effort in explaining why they are doing a transaction and in substantiating the efficiencies they expect to realize. This may help explain why, for example, the court of appeals ruled against the efficiencies claims in the Heinz/BeechNut baby food merger.[5] However good a job the parties to that merger did at the agency level and before the district court in explaining their efficiencies claims, in their briefs and oral arguments to the U.S. Court of Appeals for the D.C. Circuit, they focused more on arguing that efficiencies were relevant than on defending the district court's finding that the efficiencies were substantial and merger-specific. The result was a court of appeals decision that dismissed the efficiencies based on largely spurious reasoning.[6]

Two remedies may be suggested in this regard. The first is for antitrust lawyers to learn that the first question they should ask their client about any proposed merger is: Why? Why do you want to merge? What do you hope to accomplish? It is critical as planning proceeds, and management and board presentations are prepared, that the potential efficiencies the parties expect to realize be a major area of focus and, therefore, be clearly explained. There simply are too many cases where more effort goes into computing HHIs than into estimating cost savings.

The second remedy is for lawyers, once they have a good efficiencies story, to let their clients relate it to the agency. It is astonishing how many lawyers, with a CEO who feels passionately about the benefits a merger will deliver to her customers and shareholders, will feel that they, and not the CEO, should be the ones to try to explain those benefits to the agency. It is almost always more effective to bring the CEO or another senior executive into the agency and let them tell the story themselves (with adequate preparation, of course).

Second, efficiencies are part of the competitive effects story, not an affirmative defense. One of the most significant innovations in the Merger Guidelines occurred in 1984 when Paul McGrath and Rick Rule adopted the approach advocated by the Areeda and Turner treatise[7] and integrated efficiencies into the competitive effects analysis. The implications of this integration are twofold.

First, at the agency level, it means that the agencies need to examine efficiencies in determining whether a merger is likely to lead to either a coordinated or unilateral price increase. Indeed, based on current economic learning, it would be impossible not to. There is no way, for example, to determine whether a merger will give a firm the incentive to raise prices, even if it gives the firm the ability to do so, without examining what effect the merger will have on the merged firm's costs.

Second, before the courts, it means that efficiencies can be used, just like ease of entry or other factors, to rebut the *Philadelphia National Bank*[8] presumption of illegality based on market shares and concentration. Efficiencies can be used in this manner most effectively if the parties can show that because of the efficiencies it will produce, the merger will enable them to compete more effectively against other, larger rivals, thereby driving industry prices down, rather than up.

Viewing efficiencies as part of the competitive effects analysis has significant implications for the burden of proof. Prior to 1992, the DOJ Merger Guidelines required parties to have "clear and convincing evidence" to support their efficiencies claims. The agencies' decision to abandon this requirement in the 1992 joint DOJ / FTC Horizontal Merger Guidelines was a sound one. There is simply no justification for imposing on the parties a heavier burden with respect to efficiencies than with respect to other rebuttal evidence, or, for that matter, a heavier burden than the agencies have to meet to prove an anticompetitive effect when they go to court. While it is entirely appropriate to place the burden of coming forward with substantiation for efficiency claims on the parties making them, the ultimate burden of persuasion always remains with the agency, and there is no rational basis, in law or policy, for trying to impose a heavier burden of proof on the parties with respect to efficiencies than with respect to other types of rebuttal evidence.

Third, take footnote 37 seriously. One of the most important things I learned during my fifteen months at the Division is that the first sentence of footnote 37 of the 1997 revisions to the Horizontal Merger Guidelines[9] means what it says. The Division, at least, does not apply a strict consumer welfare test to efficiencies claims. Just as footnote 37 states, the Division will consider efficiencies even if they do not have a direct, short-term effect on price. And as one of the Division's senior economists, Ken Heyer, puts it, why would you not? Why would you ever want to block a merger, even if it may result in a small increase in price to some set of consumers, if it will, overall, make society better off by conserving scarce resources through greater efficiencies? As footnote 37 also states, while the agencies will consider efficiencies that do not immediately and directly benefit consumers, it is likely to discount those efficiencies substantially, especially the more distant they are in time.

Fourth, efficiencies come in many forms other than production cost savings. Lawyers, even antitrust lawyers, seem to have an unduly restricted understanding of efficiencies. We too often think of efficiencies over-simplistically, in terms of cost savings, usually from economies and scale or scope. As Dick demonstrates in the appendix to the *Dick/Kolasky Paper*, this is almost exactly the wrong way to think about efficiencies.[10] Even in horizontal mergers, the most substantial efficiencies are likely to result from combining complementary assets, what business people often refer to as "synergies."[11] Complementary assets can in theory be combined through contract, but transactions costs almost always get in the way. So any understanding of efficiency claims requires a thorough understanding of transactions cost economics.[12]

The appendix to the *Dick/Kolasky Paper* shows that another important type of efficiency resulting from vertical mergers and mergers of complements are allocative efficiencies—whether through the elimination of double marginalization or a Cournot effect. In either case, the merged firm will have an incentive, post-merger, to charge prices closer to marginal cost, thereby enhancing allocative efficiency.

A third type of efficiency that receives far too little attention are dynamic efficiencies. These include efficiencies that are triggered by the need for rivals to become more efficient in order to continue to compete against a more efficient merged firm. Steve Salop and Gary Roberts have written a very good article on this subject.[13]

Fifth, do not apply too high a standard of merger specificity. The joint DOJ/FTC Horizontal Merger Guidelines have always insisted that efficiencies be merger-specific—that is, that they are unlikely to be achieved but for the merger. This is a generally sound requirement, but it can easily be misused to place nearly insuperable barriers to good efficiencies claims.

The first danger is that the agencies or courts will confuse "would" for "could." The 1997 revisions to the Horizontal Merger Guidelines correctly focus on whether the claimed efficiencies are "likely" to be achieved without the merger. This is clearly the right test, and is one that takes into account the comparative cost and time that would be required to achieve comparable efficiencies through other means, including, most importantly, the transactions costs associated with doing so. It also takes into account the price effects of internal expansion, which may be a real disincentive to achieving efficiencies through internal growth rather than merger.

The second danger is that the agencies or courts will place the burden of proving merger-specificity on the wrong party. The current guidelines could be read to require the parties to prove a negative claim: The efficiencies are not likely to be achieved by other means. This is not only inconsistent with the allocation of burdens of proof generally, but is also inconsistent with Section 1 of the Sherman Act. Under Section 1, once a defendant shows that an alleged restraint will produce substantial efficiencies, the burden of going forward shifts back to the plaintiff to show that there are less restrictive means to accomplish that legitimate objective without restraining trade. It is difficult to discern why the allocation of the burden of going forward should be different under Section 7 than it is under Section 1.

The third danger is that the agencies or courts will apply the requirement of merger-specificity over-broadly. Once they integrate efficiencies into the competitive effects analysis, it is perplexing as to why the agencies should require that the efficiencies would be unlikely to be achieved but for the merger if they are persuaded that the efficiencies will enhance competition, which might be the case, for example, if the merger is likely to create a maverick by making the merged firm more efficient than its rivals. The agencies should require merger-specificity only when they believe that, but for the efficiencies, there would be a serious danger that the merger will be anticompetitive. Otherwise, they risk making the same mistake the FTC made in *California Dental*—requiring the parties to justify a transaction before the agency meets its initial burden of proving, empirically, that it is likely to harm consumers.[14]

Sixth, remember the sliding scale. There is no doubt that efficiencies will be most decisive in otherwise close cases, where the evidence of anticompetitive effect is relatively weak. As the Horizontal Merger Guidelines state, efficiencies will almost never justify a merger to monopoly or near-monopoly. A rigorous application of the SSNIP test for market definition will often result in markets being defined very narrowly; indeed, under conditions of price discrimination each customer may actually represent a separate market. As a result, we may have situations where a merger may enable the merged firm to raise prices in one or more very small markets, but will deliver substantial efficiency benefits to a much larger number of consumers in other markets. In these circumstances, even a merger to monopoly may be justified by these out-of-market efficiencies, if they are inextricably intertwined with the competitive injury—that is, if there is no way to remedy the competitive harm in some markets without sacrificing the efficiencies in others.[15] This was exactly the situation in the natural gas gathering merger described in the *Dick/Kolasky Paper*; this also was the reason the FTC cleared that merger.[16]

More generally, it is almost tautological that the greater and more certain the likely anticompetitive effects of a merger, the greater and more certain the efficiencies must be in order to outweigh them. In practice, however, the issue will rarely, if ever, be presented in this way. Instead, it will generally be presented as a more binary question, with the parties arguing that the merger will enhance competition by enabling them to compete more effectively against other, larger rivals. This was certainly the way the issue was presented in baby foods, and it is also how it was presented in EchoStar/DirecTV. In these circumstances, an evaluation of the efficiencies claim does not really involve a weighing of the cost savings from the claimed efficiencies against the potential price increases from an increase in market power, but instead requires understanding how the efficiencies will change the competitive dynamics of the market.

The agencies should require merger-specificity only when they believe that, but for the efficiencies, there would be a serious danger that the merger will be anticompetitive.

Baby foods provides a perfect illustration. The history of pricing in the baby food industry appears to have a fit leader-follower dominant firm model, with the less efficient smaller rivals (Heinz and BeechNut) pricing under the more efficient dominant firm's umbrella.[17] In these circumstances, a strong argument could be made that even if the merger would have facilitated more effective coordination, as the court of appeals presumed, the post-merger profit-maximizing duopoly equilibrium price could well have been lower than the premerger price, given the efficiencies the merged firm expected to realize. This arguably would have been a more credible argument than the argument the parties advanced, namely, the efficiencies would have given the merged firm an incentive to behave as more of a maverick, an argument the court of appeals understandably found difficult to accept in a three-to-two merger.

Seventh, fixed cost savings matter. Everyone would agree that applying a consumer welfare standard, variable cost savings should be entitled to greater weight than fixed cost savings since prices, at least in the absence of price discrimination, are determined by marginal cost. But we should not make the mistake of assuming, therefore, that fixed cost savings are entitled to no weight at all. There are two reasons for this suggestion.

First, which costs are variable depends in part on how long our time horizon is. With a longer horizon, costs that might otherwise appear fixed may indeed impact marginal pricing decisions. This is well illustrated by the DOJ's predation case against American Airlines, where the government argued that the court should look at the cost of adding flights, rather than the cost of a single seat, as the correct measure of marginal cost.[18]

Second, under conditions of price discrimination, prices to most customers are not set at marginal cost, but are set at a level designed to recover common costs that would not be viewed as variable under a strict variable cost standard.[19] In these circumstances, "fixed" cost savings for items such as recurring R&D or even G&A overhead will reduce common costs so as to benefit consumers directly, even in the short term.

Eighth, remember that efficiencies are important in designing an appropriate remedy. When we talk about efficiencies, we generally think of them in terms of a defense that can be used to rebut the inference of anticompetitive effect arising from an increase in market concentration. But efficiencies arguments play an equally, or perhaps even more, vital role in designing remedies. The scope of the divestiture the government will require may well depend on whether the agency is persuaded that the merger overall will be efficiency-enhancing. The consent decree the Division accepted in the Premdor/Masonite merger is a good illustration.[20] That case involved a proposed vertical merger between the largest manufacturer of residential doors and the largest supplier of molded door skins, a key input. Smaller competing downstream door manufacturers persuaded the Division that the merger would be anticompetitive because it would facilitate coordination by creating a second major vertically integrated residential door manufacturer. The parties argued, conversely, that the merger was necessary to enable them to compete against the other major door manufacturer, who was already vertically integrated. The Division was persuaded that these efficiencies were real, and, therefore, required the divestiture of only one of Masonite's three door skin plants, allowing the parties to capture the claimed efficiencies while also preserving an independent, non-vertically-integrated door skin supplier.

Ninth, make your efficiencies arguments first to your customers. Anyone who practices before the agencies knows that the single most essential factor in determining whether one receives a Second Request is how one's customers react to one's proposed merger and what they tell the agencies when they call during the first thirty days. For that reason, one should always make one's efficiencies arguments to one's customers before one makes them to the agencies. I always counsel my clients that the first thing they should do when they announce a merger is to get on the phone to their customers and sell those customers on the merger by explaining how it will benefit them. For if one's customers are not persuaded, the agencies will not be either.

Tenth, do not read too much into the merger outcomes literature. When we first began talking with our colleagues in Brussels about the importance of integrating efficiencies into the competitive effects analysis, one of the objections we heard most frequently was: Why should we give the parties' efficiencies claims any credence given all the studies that show that most mergers fail? There have now been three recent, very thorough reviews of the merger outcome literature,[21] and the FTC held a two-day workshop on this subject on December 9 and 10, 2002.

We can sum up what these studies show in a single sentence: Some mergers deliver, others do not. Unfortunately, the studies are all over the lot on what percentage of mergers fall into each of these two groups, but most seem to place the percentage of successful mergers somewhere between 40 and 60 percent.

The key question is what conclusions we should draw from these studies. Most of the studies look at the impact of mergers on shareholder value, generally as measured by share prices. These studies tell us very little that is useful for antitrust decision-makers. If a merger fails to deliver shareholder value, it may well be that it did not create any substantial efficiencies, but it is even more likely that it did not result in any increase in market power. Efficiencies might not deliver shareholder value if they are matched by rivals; market power almost certainly would. A number of studies do try to look directly at the success of mergers in realizing the efficiencies that were predicted and at the effects of mergers on prices. These studies basically tell us what we already know: That evaluating the competitive effects of mergers, even after they occur, is very difficult and very fact-intensive, so that almost any generalization is certain to be wrong.

The conclusion I draw from these studies is that we have no more reason to be skeptical of the parties' ability to forecast accurately the efficiencies they will achieve than we should be of our own ability to forecast accurately that a merger will create or strengthen market power. As Yogi Berra taught us, "It's dangerous to make predictions, especially about the future." But that does not mean that we should give up trying. I see no way for an agency to appraise the likely competitive effects of a merger without examining any potential efficiencies, any more than it could do so without looking at the effect on the parties' ability and incentive to raise price, either unilaterally or through coordination with other firms. How can we predict whether a merger will result in a unilateral price increase without examining how it will affect the merged firm's costs? And how can we evaluate the likelihood or effect of coordination without looking at whether the merger, by reducing the firm's costs, will either give the firm an incentive to behave more as a maverick or otherwise reduce the likely post-merger equilibrium price?

NOTES

1. Mario Monti, *Review of the EC Merger Regulation — Roadmap for the Reform Project*, Speech before the Conference on Reform of European Merger Control, British Chamber of Commerce, Brussels (June 4, 2002); Mario Monti, *The Future for Competition Policy in the European Union (Extracts) Merger Control: Issues Highlighted in the Context of the*

GE/Honeywell Merger, Speech delivered at Merchant Taylor's Hall, London (July 9, 2001).

2. William J. Kolasky & Andrew R. Dick, *The Merger Guidelines and the Integration of Efficiencies Into Antitrust Review of Horizontal Mergers*, Paper delivered on the 20th anniversary of the 1982 Merger Guidelines (June 10, 2002) [hereinafter the *Dick/Kolasky Paper*].

3. *See* Gotz Drauz, *Unbundling GE/Honeywell: The Assessment of Conglomerate Mergers Under EC Competition Law*, 25 Fordham Int'l L.J. 885, 905 (2002).

4. Timothy J. Muris, *The Government and Merger Efficiencies: Still Hostile After All These Years*, 7 George Mason L. Rev. 729 (Spring 1999); William J. Kolasky, *Lessons From Baby Food: The Role of Efficiencies in Merger Review*, 16 Antitrust 82 (Fall 2001).

5. FTC v. H.J. Heinz Co., 246 F.3d 708 (D.C. Cir. 2001).

6. William J. Kolasky, *Lessons From Baby Food: The Role of Efficiencies in Merger Review*, 16 Antitrust 82 (Fall 2001).

7. *Dick/Kolasky Paper*, at 49-61.

8. Phillip E. Areeda & Donald F. Turner, Antitrust Law: An Analysis of Antitrust Principles and Their Application 146-99 (1980).

9. United States v. Philadelphia Nat'l Bank, 374 U.S. 321 (1963).

10. Footnote 37 contains the following text:

The result of this analysis over the short term will determine the Agency's enforcement decision in most cases. The Agency also will consider the effects of cognizable efficiencies with no short-term, direct effect on prices in the relevant market. Delayed benefits from efficiencies (due to delay in the achievement of, or the realization of consumer benefits from, the efficiencies) will be given less weight because they are less proximate and more difficult to predict.

See infra note 14.

11. Joseph Farrell & Carl Shapiro, *Scale Economies and Synergies in Horizontal Merger Analysis*, 68 Antitrust L.J. 685 (2001); Gregory Werden, *An Economic Perspective on the Analysis of Merger Efficiencies*, 11 Antitrust 12 (Summer 1997).

12. For a detailed explanation of transactions cost economics, *see generally* Oliver F. Williamson, The Economic Institutions of Capitalism (1985).

13. Gary L. Roberts & Steven C. Salop, *Efficiencies in Dynamic Merger Analysis*, 19 World Competition L. & Econ. Rev. 5 (1996).

14. California Dental Ass'n v. FTC, 526 U.S. 756 (1999).

15. *See* Dep't of Justice & Federal Trade Comm'n, Horizontal Merger Guidelines § 4 (1992), *reprinted in* 4 Trade Reg. Rep. (CCH) ¶ 13,104 (revised 1997).

16. *Dick/Kolasky Paper*, at 32-33.

17. *In re* Baby Food Antitrust Litig., 166 F.3d 112 (3d Cir. 1999).

18. United States v. AMR Corp., 140 F. Supp. 2d 1141 (D. Kan. 1999).

19. Michael E. Levine, *Price Discrimination Without Market Power*, 19 Yale Journal on Regulation 1 (Winter 2002); William J. Baumol, The Free-Market Innovation Machine: Analyzing the Growth Miracle of Capitalism (2002).

20. United States v. Premdor, Inc., 2002-2 Trade Cas. (CCH) ¶ 73,737 (D.D.C. Apr. 5, 2002).

21. Paul A. Pautler, *Evidence on Mergers &*

Acquisitions (FTC, working paper, Sept. 25, 2001); Ilene K. Gotts & Calvin S. Goldman QC, *The Role of Efficiencies in M&A Global Antitrust Review: Still in Flux?* (working title, forthcoming); Directorate-General for Economic & Financial Affairs, European Comm'n, The Efficiency Defence & The European System of Merger Control (2001). ❖